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with his client or customer if, with respect to such expense for entertainment, he submits to his client or customer adequate records or other sufficient evidence conforming to the requirements of paragraph (c) of this section.

(4) *Substantiation by client or customer.* A client or customer shall not be required to substantiate, in accordance with the requirements of paragraph (c) of this section, reimbursements to an independent contractor for travel and gifts, or for entertainment unless the independent contractor has accounted to him (within the meaning of section 274(e)(4)(B) and subparagraph (3) of this paragraph) for such entertainment. If an independent contractor has so accounted to a client or customer for entertainment, the client or customer shall substantiate each element of the expenditure (as described in paragraph (b) of this section) in accordance with the requirements of paragraph (c) of this section.

(h) *Authority for an optional method of computing meal expenses while traveling.* The Commissioner may establish a method under which a taxpayer may elect to use a specified amount or amounts for meals while traveling in lieu of substantiating the actual cost of meals. The taxpayer would not be relieved of substantiating the actual cost of other travel expenses as well as the time, place, and business purpose of the travel. See paragraph (b)(2) and (c) of this section.

(i) *Effective date—(1) In general.* Section 274(d) and this section apply with respect to taxable years ending after December 31, 1962, but only with respect to period after that date.

(2) *Certain meal expenses.* Paragraph (h) of this section is effective for expenses paid or incurred after December 31, 1982.

[T.D. 6630, 27 FR 12931, Dec. 29, 1972, as amended by T.D. 7226, 37 FR 26711, Dec. 15, 1972; T.D. 7909, 48 FR 40370, Sept. 7, 1983; 48 FR 41017, Sept. 13, 1983; T.D. 8051, 50 FR 36576, Sept. 9, 1985. Redesignated by T.D. 8715, 62 FR 13990, Mar. 25, 1997]

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TERMINAL RAILROAD CORPORATIONS AND THEIR SHAREHOLDERS

§ 1.281-1 In general.

Section 281 provides special rules for the computation of the taxable incomes of a terminal railroad corporation and its shareholders when the terminal railroad corporation, as a result of taking related terminal income into account, reduces a charge which was made or which would be made for related terminal services furnished to a railroad corporation. Section 281 and paragraphs (a) and (b) of § 1.281-2 provide that the “reduced amount” described in paragraph (c) of § 1.281-2 is not includable in gross income of the terminal railroad corporation, is not treated as a dividend or other distribution to its railroad shareholders, and is not treated as an amount paid -or incurred by the railroad shareholders to the terminal railroad corporation. Section 281 and paragraph (a)(2) of § 1.281-2 provide that no deduction otherwise allowable to a terminal railroad corporation shall be disallowed as a result of the “reduced amount” described in paragraph (c) of § 1.281-2. Section 1.281-3 defines the terms *terminal railroad corporation*, *related terminal income*, *related terminal services*, *agreement*, and *railroad corporation*. Section 1.281-4 describes the effective dates and special rules for application of section 281 to taxable years ending before October 23, 1962.

[T.D. 7356, 40 FR 23732, June 2, 1975]

§ 1.281-2 Effect of section 281 upon the computation of taxable income.

(a) *Computation of taxable income of terminal railroad corporations—(1) Income not considered received or accrued.* A terminal railroad corporation (as defined in paragraph (a) of § 1.281-3) shall not be considered to have received or accrued the “reduced amount” described in paragraph (c) of this section in the computation of its taxable income. Thus, income is not to be considered accrued or actually or constructively received by a terminal railroad corporation where, in the manner described in paragraph (c) of this section, (i) a charge which would be made to

any railroad corporation for related terminal services is not made, or (ii) a portion of any liability payable by any railroad corporation with respect to related terminal services is discharged.

(2) *Deduction not disallowed.* In the computation of the taxable income of a terminal railroad corporation, a deduction relating to a “reduced amount”, described in paragraph (c) of this section, which is otherwise allowable to it under chapter 1 of the Code (without regard to sec. 277) shall not be disallowed by reason of section 281. Thus, deductions for expenses attributable to services rendered to a shareholder are not to be disallowed to a terminal railroad corporation merely because, in the manner described in paragraph (c) of this section, (i) a charge which would be made to any railroad corporation for related terminal services is not made, or (ii) a portion of any liability payable by any railroad corporation with respect to related terminal services is discharged. To the extent that section 281 applies to a deduction relating to a “reduced amount”, such deduction shall not be disallowed under section 277.

(b) *Computation of taxable income of shareholders—*(1) *Income not considered received or accrued.* A shareholder of a terminal railroad corporation shall not be considered to have received or accrued any “reduced amount” (described in paragraph (c) of this section) in the computation of the shareholder’s taxable income. Thus a dividend is not to be considered actually or constructively received by a shareholder of a terminal railroad corporation merely because, in the manner described in paragraph (c) of this section, (i) a charge which would be made to the shareholder or any other railroad corporation for related terminal services is not made, or (ii) a portion of any liability payable by it or any other railroad corporation with respect to related terminal services is discharged.

(2) *Expenses not considered paid or incurred.* In the computation of the taxable income of a shareholder of a terminal railroad corporation, the shareholder shall not be considered to have paid or incurred any “reduced amount” (described in paragraph (c) of this section). Thus, a shareholder of the ter-

terminal railroad corporation may not deduct as an expense for related terminal services (as defined in paragraph (c) of § 1.281-3) an amount in excess of the net cost to it of such services.

(c) *Amounts to which section 281 applies—*(1) *Reduced amount.* For purposes of this section, the term *reduced amount* means, subject to the limitation of paragraph (c)(4) of this section, the amount by which:

(i) A charge which would be made by a terminal railroad corporation for its taxable year for related terminal services provided to a railroad corporation; or

(ii) A liability of a railroad corporation, resulting from a charge made by a terminal railroad corporation for its taxable year, with respect to related terminal services provided by the terminal railroad corporation, is reduced by reason of the terminal railroad corporation’s taking into account, pursuant to an agreement (as defined in paragraph (d) of § 1.281-3), related terminal income (as defined in paragraph (b) of § 1.281-3) received or accrued (without regard to section 281) during such taxable year.

(2) *Charge which would be made.* For purposes of this section, a “charge which would be made” by a terminal railroad corporation is the amount that would be charged to any railroad corporation for related terminal services provided if the terminal railroad corporation made the charge without taking related terminal income into account.

(3) *Reduction resulting from related terminal income.* For purposes of subparagraph (1) of this section, a charge or a liability is reduced by taking related terminal income into account to the extent that:

(i) Related terminal income is received or accrued (without regard to section 281) by the terminal railroad corporation for its taxable year in which the charge or liability is reduced; and

(ii) The charge or liability in question would have been larger than it is had such income not been received or accrued (without regard to section 281). The reduction must be made (directly or indirectly) on the books of the terminal railroad corporation, and in fact,

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for the same taxable year for which the charge would be made or for which the liability is incurred. The reduction of the charge or liability must be taken into account by the terminal railroad corporation in ascertaining the income, profit, or loss for such taxable year for the purpose of reports to shareholders and the Interstate Commerce Commission, and for credit purposes.

(4) *Limitation.* To the extent that a reduced amount (as described in paragraph (c)(1) of this section but without regard to the limitation under this subparagraph) would operate either to create or to increase a net operating loss for the terminal railroad corporation, this section shall not apply. Therefore, if a portion of a liability is discharged (in the manner described in this paragraph) and the discharged portion of the liability exceeds an amount equal to the terminal railroad corporation's gross income minus the deductions allowed by chapter 1 of the Code (computed with regard to the modifications specified in section 172(d) but without regard to section 281 and this section), then section 281 and this section shall not apply to such excess. The limitation described in this subparagraph shall apply only to taxable years of terminal railroad corporations ending after October 23, 1962.

(d) *Examples.* The provisions of this section may be illustrated by the following examples. In these examples, references to "before the application of section 281", "after the application of section 281", "taxable income", and "allowable deductions" take no account of section 277, which may apply to deductions to which section 281 does not apply.

Example 1 (i) Facts. The T Company is a terminal railroad corporation which charges its three equal shareholders, the X, Y, and Z railroad corporations, a rental calculated monthly on a wheelage or user basis for the use of its services and facilities. The T Company and each of its shareholders report income on the calendar year basis. A written lease agreement to which all of the shareholders were parties was entered into in 1947. The agreement provides that at the end of each year the liabilities of each of the shareholders resulting from charges for rental obligations with respect to related terminal services shall be reduced by the share-

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holder's one-third share of the net income from each source of revenue that produced income (computed before reduction for Federal income taxes). For the calendar year 1973, the T Company's charges to its shareholders include the following charges for related terminal services: \$35,000 to the X Company, \$25,000 to the Y Company, and \$20,000 to the Z Company. Thus, prior to reduction, total shareholder liabilities to the T Company for related terminal services are \$80,000 at the end of 1973. The T Company's net income from all sources (before reduction of liabilities pursuant to the 1947 agreement and before reduction for Federal income taxes) and its taxable income, before the application of section 281, for 1973 are \$36,000 determined as follows:

Source	Gross income	Allowable deductions	Income (or loss)
Related terminal services performed:			
For shareholders	\$80,000	\$65,000	\$15,000
For nonshareholders	46,000	37,000	9,000
Related terminal income	126,000	102,000	24,000
Nonrelated terminal income	30,000	18,000	12,000
Total	156,000	120,000	36,000

The liability of each shareholder is, pursuant to the agreement, discharged in part by the T Company crediting \$12,000 against the rental due from each shareholder for a total discharge of liabilities of \$36,000 (the net income from all sources), resulting in net shareholder liabilities owing to the T Company at the end of 1973 of \$44,000 (\$80,000 less \$36,000): \$23,000 from the X Company, \$13,000 from the Y Company, and \$8,000 from the Z Company.

(ii) *Effect on terminal railroad corporation.* The reduced amount to which this section applies is \$24,000 (related terminal income of \$9,000 from nonshareholders and \$15,000 from shareholders). Thus, to the extent of \$24,000, the T Company is not considered to have received or accrued income from the discharged liabilities of \$36,000. Similarly, to the extent of the same \$24,000, the T Company is not disallowed deductions for expenses merely by reason of the discharge. The T Company's taxable income for 1973 after application of section 281 is \$12,000, computed as follows:

Gross income (\$156,000 less \$24,000)	\$132,000
Less allowable deductions	120,000
Taxable income	12,000

(iii) *Effect on shareholders*—The reduced amount of \$24,000 shall not be deemed to constitute either a dividend to the shareholders

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of the T Company or an expense paid or incurred by them. Thus, under the facts described, neither the X Company, the Y Company, nor the Z Company shall be considered to have received or accrued a dividend of \$8,000, or to have paid or incurred an expense of \$8,000. Assuming the X Company's taxable income for 1973 before the application of section 281 would have been \$43,200, computed in the following manner, its taxable income for 1973 after the application of section 281 is \$50,000, determined as follows:

	Before the application of sec. 281	After the application of sec. 281
Gross income:		
From sources other than T Co ..	\$146,000	\$146,000
Dividend considered received because of T Co.'s discharge of liabilities of \$12,000	12,000	4,000
Total	158,000	150,000
Less allowable deductions:		
From sources other than T Co ..	69,600	69,600
85 percent dividend received deduction under sec. 243 attributable to dividend considered received because of T Co.'s discharge of liabilities	10,200	3,400
Expenses for accrued charges for related terminal services performed by T Co	35,000	27,000
	114,800	100,000
Taxable income	43,200	50,000

Example 2. Assume the same facts as in *Example (1)*, except that the charges to each of the shareholders for related terminal services for 1973 were as follows: \$35,000 to the X Company, \$40,000 to the Y Company, and \$5,000 to the Z Company. Assume further that the Z Company, prior to the reduction in liabilities at the end of 1973, owed the T Company an additional \$4,000 resulting from charges for 1972 for related terminal services and \$6,000 resulting from the purchase of equipment. Since only \$21,000 (X Company \$8,000, Y Company \$8,000, Z Company \$5,000) of the liabilities which were discharged resulted from charges made for 1973 for related terminal services, the reduced amount to which this section applies is \$21,000 (instead of \$24,000 as in *Example (1)*). Thus, the T Company's taxable income for 1973 would be \$15,000 (\$36,000 less \$21,000 reduced amount) and the amount which shall be considered not to have been received or accrued as a dividend nor paid or incurred as an expense of each shareholder is \$8,000 for the X Company, \$8,000 for the Y Company, and \$5,000 for the Z Company.

Example 3. Assume the same facts as in *Example (1)*, except that the allowable deductions with respect to nonrelated terminal activities were \$39,000 instead of \$18,000. The T

Company's net income from all sources (before reduction for Federal income taxes) and its taxable income, before the application of section 281, is therefore \$15,000, determined as follows:

Source	Gross income	Allowable deductions	Income (or loss)
Related terminal income	\$126,000	\$102,000	\$24,000
Nonrelated terminal income	30,000	39,000	(9,000)
Total	156,000	141,000	15,000

The liability of each shareholder is nevertheless discharged in part, pursuant to the agreement, by the T Company crediting \$8,000 against the rental due from each shareholder for a total discharge of liabilities of \$24,000 (the net income from each source of revenue that produced income). Assume further that none of the modifications specified in section 172(d) apply. If the limitation under paragraph (c)(4) of this section were not applied, the reduced amount for the purposes of this section would be \$24,000, and the operation of this section would result in a net operating loss of \$9,000, since the allowable deductions of \$141,000 would exceed the gross income of \$132,000 (\$156,000 less discharged liabilities of \$24,000) by that amount. Because of the limitation under paragraph (c)(4) of this section, however, \$9,000 is not included in the reduced amount to which this section applies. Accordingly, the reduced amount is \$15,000 (instead of \$24,000 as in *Example (1)*). Thus, the T Company's taxable income for 1973 would be zero (\$15,000 less the \$15,000 reduced amount), and the amount which each shareholder shall be considered not to have received or accrued as a dividend nor paid or incurred as an expense is \$5,000.

Example 4. Assume the same facts as in *Example (1)*, except that under the agreement income from the terminal parking lot would not reduce the shareholders' liabilities. Assume further that such income amounted to \$3,000 of the total related terminal income of \$24,000 for the taxable year 1973. The liability of each shareholder therefore is discharged by crediting \$11,000 against its rental due for a total discharge of liabilities of \$33,000. The reduced amount to which this section applies is \$21,000 (\$24,000 less \$3,000) since only to the extent of \$21,000 would there have been no such reduction under the agreement if there were no related terminal income.

Example 5. Assume the same facts as in *Example (1)*, except that, pursuant to the agreement, the A Company, a nonshareholder railroad corporation, is to have its liabilities resulting from charges for rental obligations

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reduced equally with each of the shareholders. Assume further that the T Company's charges to the A Company for the calendar year 1973 included \$15,000 for related terminal services and that the liability of each shareholder and the A Company is discharged in part pursuant to the agreement by the T Company crediting \$9,000 against the rental due from each. The reduced amount to which this section applies is \$24,000. Thus, the T Company's taxable income for 1973 is \$12,000, and each shareholder shall not be considered to have received or accrued as a dividend nor paid or incurred as an expense \$6,000 (\$24,000/ \$36,000 × \$9,000) merely because of the discharge of its own liability. Similarly, each shareholder shall not be considered to have received or accrued as a dividend nor paid or incurred as an expense \$2,000 ($\frac{1}{3} \times (\$24,000/\$36,000 \times \$9,000)$) merely because of the discharge of the liability of the A Company. Section 281 does not apply to the determination of the tax consequences of the transaction to the A Company. Similarly, the section does not apply to the determination of the tax consequences to the shareholders resulting from that portion of the discharge of the liability of the A Company which is attributable to the application of income which is not related terminal income (\$3,000). Hence, such consequences shall be determined under the sections of the Internal Revenue Code which govern in the absence of section 281.

Example 6. (i) *Facts.* The TR Company is a terminal railroad corporation with three equal shareholders, the M, N, and O Railroad Corporations. The TR Company and each of its shareholders report income on the calendar year basis. Pursuant to a written agreement entered into in 1947 to which all shareholders were parties, the TR Company makes one annual charge to each of the three shareholders at the end of each year for the difference between the cost of operations, allocated on a wheelage or user basis for the use of its services and facilities provided to the shareholder during the year, and one-third of its net income from all other sources (computed before reduction for Federal income taxes). The TR Company's taxable income, before the application of section 281, for 1973 is \$21,000 determined as follows:

Source	Gross income	Allowable deductions	Income (or loss)
Related terminal services performed:			
For shareholders ..	\$65,000	\$65,000	0
For nonshareholders	46,000	37,000	\$9,000
Related terminal income	111,000	102,000	9,000

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Source	Gross income	Allowable deductions	Income (or loss)
Nonrelated terminal income from nonshareholders	30,000	18,000	12,000
Total	141,000	120,000	21,000

For the calendar year 1973, the TR company's charges to its shareholders are \$23,000 (\$30,000 less \$7,000) to the M company, \$13,000 (\$20,000 less \$7,000) to the N company, and \$8,000 (\$15,000 less \$7,000) to the O company for a total of \$44,000 for related terminal services.

(ii) *Effect on terminal railroad corporation.* The reduced amount to which this section applies is \$9,000. The TR company is not considered to have received or accrued income of \$9,000 (related terminal income) merely because the charge of \$21,000 (net income from all sources other than shareholders) was not made. Similarly, to the extent of \$9,000, the TR company is not disallowed deductions for expenses merely because the full cost of services was not charged. The TR company's taxable income for 1973 after application of section 281, is \$12,000, computed as follows:

Gross income (\$141,000 less \$9,000 charges not made)	\$132,000
Less allowable deductions	120,000
Taxable income	12,000

(iii) *Effect on shareholders.* Neither the M company, the N company, nor the O company shall be considered to have received or accrued a dividend of \$3,000 nor to have paid or incurred an expense of \$3,000 merely by reason of the reduced charges. Thus, assuming the M company's taxable income for 1973 before the application of section 281 would have been \$47,450, computed in the following manner, its taxable income for 1973 after the application of section 281 is \$50,000, determined as follows:

	Before the application of sec. 281	After the application of sec. 281
Gross income:		
From sources other than TR Co	\$146,000	\$146,000
Dividend considered received because of TR Co.'s reduction of charges	7,000	4,000
Total	153,000	150,000
Less allowable deductions:		
From sources other than TR Co	69,600	69,600
85 percent dividend received deduction under sec. 243 attributable to dividend considered received because of TR Co.'s reduction of charges	5,950	3,400

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	Before the appli- cation of sec. 281	After the applica- tion of sec. 281
Expenses for accrued charges for re- lated terminal services performed by TR Co	30,000	27,000
	105,550	100,000
Taxable income	47,450	50,000

[T.D. 7356, 40 FR 23733, June 2, 1975]

§ 1.281-3 Definitions.

(a) *Terminal railroad corporation.* The term *terminal railroad corporation* means a corporation which, in the taxable year, meets all of the following conditions:

(1) The corporation and each of its shareholders must be domestic corporations. Thus, all of the shareholders of the corporation, as well as the corporation itself, must be corporations which were organized or created in the United States, including only the States and the District of Columbia, or under the law of the United States or of any State or territory.

(2) All of the shareholders must be railroad corporations which are subject to Part I of the Interstate Commerce Act. Thus, if any shareholder of the corporation, regardless of the class or percentage of stock owned, is not subject to the jurisdiction of the Interstate Commerce Commission under part I of that Act, the corporation cannot qualify as a terminal railroad corporation.

(3) The corporation must not be a member of an affiliated group of corporations (as defined in section 1504), other than as a common parent corporation. For this purpose it is immaterial whether or not the affiliated group has ever made a consolidated income tax return. Thus, if the X railroad corporation owns 80 percent of all of the outstanding stock of the Y railroad corporation, the X railroad corporation may qualify, but the Y railroad corporation cannot qualify, as a terminal railroad corporation.

(4) The primary business of the corporation must be that of providing to domestic railroad corporations subject to Part I of the Interstate Commerce Act and to the shippers and passengers of such railroad corporations one or

more of the following facilities or services: (i) Railroad terminal facilities, (ii) railroad switching facilities, (iii) railroad terminal services, or (iv) railroad switching services. The designated facilities and services include the furnishing of terminal trackage, the operation of stockyards or a union passenger or freight station, and the operation of railroad bridges and ferries. The providing of the designated facilities includes the leasing of those facilities. A corporation shall be considered as having established that its primary business is that of providing the designated facilities and services if more than 50 percent of its gross income (computed without regard to section 281, and excluding dividends and gains and losses from the disposition of capital assets or property described in section 1231(b)) for the taxable year is derived from those sources. The fact that income from a service or facility is included within the definition of related terminal income is immaterial for purposes of determining whether that service or facility is one which is designated in this subparagraph. Thus, although income from the operation of a commuter railroad line may be related terminal income, a corporation whose primary business is the operation of that facility is not a terminal railroad corporation, since its primary business is not the providing of the designated facilities or services.

(5) A substantial part of the services rendered by the corporation for the taxable year must be rendered to one or more of its shareholders. For purposes of this requirement, providing the use of facilities shall be considered the rendering of services.

(6) Each shareholder of the corporation must compute its taxable income on the basis of a taxable year which either begins or ends on the same day as the taxable year of the corporation.

(b) *Related terminal income.*—(1) *In general.* Related terminal income is, generally, the type of income normally earned from the operation of a railroad terminal. The term *related terminal income* means the taxable income (computed without regard to sections 172, 277, or 281) which the terminal railroad corporation derives for the taxable year from the sources enumerated in